No. 9393

In the United States Circuit Court of Appeals for the Ninth Circuit

CO-OPERATIVE OIL ASSOCIATION, INC., AN ASSOCIATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF DECISION OF THE UNITED STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

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OPINION BELOW

The memorandum opinion of the Board of Tax Appeals (R. 22–30) is unreported.

JURISDICTION

This case involves deficiencies in the income taxes of the taxpayer for the taxable year from January 1, 1934, to October 31, 1934, and for the fiscal year ending October 31, 1935, in the sums of $1,065.25 and $1,696.33, respectively, and also deficiencies in the taxpayer's excess profits taxes for the same years in the sums of $387.36 and $618.39, respectively. (R. 23.) The appeal is taken from a decision of the Board entered July 10, 1939 (R. 31), and is brought to this Court by a petition

for review filed October 5, 1939 (R. 32–37), pursuant to the provisions of Sections 1141 and 1142 of the Internal Revenue Code.

QUESTION PRESENTED

Whether the taxpayer, a cooperative marketing association organized under the Cooperative Marketing Act of Idaho, is entitled to deductions for such "patronage dividends" as were not declared and paid during the taxable years.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved will be found in the Appendix, *infra,* pp. 14–18.

STATEMENT

The facts as found by the Board of Tax Appeals are as follows (R. 23–28):

The taxpayer is a corporation organized in 1933 as a nonprofit cooperative marketing association under the Cooperative Marketing Act of the State of Idaho, and has its principal office in Caldwell, Idaho. Its original name was Cooperative Union Oil Company of Boise Valley, State of Idaho, but on June 8, 1935, its name was changed to Cooperative Oil Association, Inc. Its charter granted to it broad general powers to purchase, sell, and deal in properties of every kind, but particularly petroleum products and automobile accessories and supplies. (R. 23–24.)

The taxpayer's authorized capital stock consisted of 5,000 shares of common stock of the par value of $1 each and 3,000 shares of redeemable nonvoting, nonparticipating 6 percent preferred stock of the par value of $5 each. Dividends on preferred stock are payable

before other stockholders may share in the earnings and are cumulative. No stock-holding patron may own more than one share of common stock nor cast more than one vote. The articles of incorporation contain the following provision (R. 24):

> The net income of this corporation, except such amounts as by law are required to be set aside for reserve funds, or which may be set aside as reserve funds, by the Board of Directors or by vote of stockholders shall be distributed to the stockholding patrons of this corporation who have signed the corporation's purchasing agreement on the basis of their patronage and as shall be provided by the Board of Directors.

The interest of each stockholding patron in the savings or earnings of the taxpayer is determined by the amount of purchases made by him. The management of the taxpayer's affairs is vested in a board of six directors. Membership in the taxpayer is limited to those engaged in the production of agriculture products and is conditioned upon the purchase of one share of common stock and the execution of a membership agreement. By that agreement members agree to purchase all gasoline and petroleum requirements from the taxpayer. If the member fails so to purchase for 60 days the taxpayer's board of directors may cancel his common stock and one share of his preferred stock and retain his share in the accumulated patronage dividends as liquidating damages. The agreement also provides as follows (R. 25):

> * * * before distribution of patronage dividends, it is the duty of the board of directors, and they shall retain and accumulate out of the

net earnings of the corporation, such amounts as in their judgment are necessary and proper to create a reserve or reserve funds necessary to provide working capital, depreciation and other reserves and the proper facilities for carrying on the business of the corporation.

Section 2, Article VIII, of the by-laws provides (R. 25):

> * * * Whenever all cumulative dividends on preferred stock for all previous years shall have become payable, and the accrued dividends for the current year shall have been declared and the corporation shall have paid such cumulative dividends for previous years, and such accrued dividends for the current year, or shall have set aside from its surplus or net profits a sum sufficient for payment thereof, the board of directors may declare other dividends or distribute earnings to the stockholding patrons of the corporation as hereinafter provided.

Section 1, Article IX of the by-laws is as follows (R. 26):

RESERVE FUNDS AND INVESTMENTS

> SECTION 1. Before distribution of patronage dividends herein provided for it shall be the duty of the board of directors, and they shall have the right to retain and accumulate out of the net earnings of the corporation such amounts as, in the judgment of said board of directors are necessary and proper to create a reserve or reserve funds necessary to provide working capital and the proper facilities for carrying on the business of the corporation.

Article X of the by-laws is as follows (R. 26–27):

NET EARNINGS

SECTION 1. The net income of this corporation except such amounts as by law are required to be set aside as reserve funds, or which may be set aside as reserve funds, or which may be set aside as reserve funds by the board of directors, or by the vote of the stockholders shall be distributed to the stockholding patrons of this corporation who have signed the corporation's purchasing agreement on the basis of their patronage and as shall be provided by the board of directors. Such patronage dividends shall be ascertained and distributed by order of the board of directors at least once during each fiscal year of the corporation, and may be so ascertained and paid by order of said board twice each fiscal year, at the discretion of the board.

When any purchase was made by a member the sales ticket covering the purchase was made out in triplicate, one copy going to the member and the other two being retained by the taxpayer. Of the latter copies, one was used for accounting purposes and the other was filed in a folder which was marked with the member's name and in which all sales tickets credited to him were kept. No accounts were set up on the general ledger of taxpayer relating to purchases made by members, but the aggregate of such transactions was entered on its books. Two reserve accounts were kept by the taxpayer, entitled "Reserve for Working Capital" and "Reserve for Contingency, Obsolescence and Extension." (R. 27.)

On May 1, 1934, the taxpayer sent to its members a circular letter containing the following statement (R. 27–28):

> *To All Members:*
>
> The attached draft or credit is only a part of your savings for the six months period ending January 31st, 1934. Your board of directors considers it desirable to retain a portion of the net profits of this period for working capital. As rapidly as our reserves accumulate these earnings will be released and disbursed to you as Patronage Refunds. In the meantime the money is being devoted to the excellent purpose of building your company and making possible larger dividends for the future.

No money was paid to members other than pursuant to resolutions of the board of directors. The portion of the current savings not released to members by authority of such resolutions was retained by the taxpayer, entered on its books as "Reserve for Working Capital" and carried on its balance sheet as a liability to its members. (R. 28.)

During the period from January 1 to November 1, 1934, the directors of the taxpayer declared dividends which were paid during that year aggregating $7,864.55. The total amount of savings for the year was $14,737.21, which the taxpayer took as a deduction on its income tax return for that period. During the fiscal year ending October 31, 1935, the directors declared and paid dividends aggregating $17,926.53. The total amount of savings for that year was $29,073.83, which the taxpayer also took as a deduction on its return for such year. (R. 28.)

Upon these findings, the Board approved the Commission's disallowance of the claimed deductions.

SUMMARY OF ARGUMENT

The taxpayer is a cooperative organized under the laws of Idaho and engaged in the business of purchasing and selling petroleum products and automobile accessories both to its members and to nonmembers. Taxpayer concedes that it is not exempt from taxation. It seeks to deduct in this case, however, the total amount of savings resulting from business with members during the taxable year. Deductions have been allowed for patronage dividends which were declared during the taxable year, but the claimed deductions for patronage dividends which were not declared and paid have been disallowed. Under well-settled principles, the taxpayer would not be entitled to the deductions in controversy as the right to these savings would not become fixed until an affirmative act of appropriation on the part of the board of directors of the corporation. The Board of Tax Appeals has carefully considered the taxpayer's articles of incorporation, bylaws, and membership agreement, and has reached the conclusion that a declaration of dividend by the board of directors was essential to the fixing of liability. That conclusion is correct and should be affirmed.

ARGUMENT

The taxpayer is not entitled to deductions for such "patronage dividends" as were not declared and paid during the taxable years

The taxpayer is a cooperative organized under the laws of the State of Idaho and engaged in the business

of purchasing and selling gas, oil, other petroleum products, and auto accessories. Its members are persons engaged in producing agricultural products, but the taxpayer does business with both members and nonmembers. It does not contend that it is an exempt corporation under Section 101 (12) of the Revenue Act of 1934, c. 277, 48 Stat. 680, *infra,* and clearly it is not. As provided in Article 101 (12)–1 of Treasury Regulations 86, *infra,* for a corporation to come within the exemption, it must treat nonmember patrons the same as members insofar as the distribution of patronage dividends is concerned. In the present case the savings on nonmember business were not paid to those nonmember patrons but were distributed to the members. (R. 72, 74, 75.) See *Farmers Union Co-op. Co.* v. *Commissioner,* 90 F. (2d) 488 (C. C. A. 8th); *Farmers Co-operative Co.* v. *United States,* 23 F. Supp. 123 (C. Cls.); *Farmers Union Co-operative S. Co.* v. *United States,* 23 F. Supp. 128, 25 F. Supp. 93 (C. Cls.). Cf. *Fruit Growers Supply Co.* v. *Commissioner,* 56 F. (2d) 90 (C. C. A. 9th). See also Mim. 3886, X–2 Cum. Bull. 164 (1931).

Although not contending that it is an exempt corporation, the taxpayer claims deductions for the total amounts of savings resulting from business with members during the taxable years in question. Such savings represent the excess of income over operating expenses attributable to the business of members.

The Commissioner allowed as deductions the amounts of savings to members for which patronage dividends were actually declared by the board of directors, but disallowed the balance of the claimed deduc-

tions. (R. 14–15, 18–19.) His action was approved by the Board. (R. 28–30.)

There is no express statutory provision permitting the deduction of so-called patronage dividends by corporations subject to taxation. The administrative practice, however, has been to permit cooperative associations, even though not exempt from taxation, to deduct from gross income the amounts returned to their patrons, whether members or nonmembers, upon the basis of the purchases or sales, or both, made by or for them. This is upon the theory that a cooperative association is organized for the purpose of furnishing its patrons goods at cost or for obtaining the highest market price for the produce furnished by them. In the case of purchases, instead of allowing a discount at the time of the purchase, the full price is collected and the discount is allowed by way of rebate. Any profits made on business with nonmembers which may be distributed to members in the guise of rebates are, of course, taxable to the association and the members. See I. T. 1499, I–2 Cum. Bull. 189 (1922); A. R. R. 6967, III–1 Cum. Bull. 287 (1924); *Trego County Cooperative Association* v. *Commissioner,* 6 B. T. A. 1275; *Home Builders Shipping Association* v. *Commissioner,* 8 B. T. A. 903; *Anamosa Farmers Creamery Co.* v. *Commissioner,* 13 B. T. A. 907; *Farmers Union Cooperative Association* v. *Commissioner,* 13 B. T. A. 969.

Where a corporation is formed and operated as was the taxpayer, clearly the proceeds from sales to its members as well as to nonmembers genuinely belong to it. It is true that those who might be entitled to patronage dividends have, in a sense, an interest in the money,

but, as it has been well said, the character of such interest is not greater than that of a stockholder in an ordinary corporation. *Farmers Union Co-op. Co.* v. *Commissioner,* 90 F. (2d) 488, 491 (C. C. A. 8th). With few exceptions, such interest ripens into an individual ownership or right of ownership only upon the actual declaration by the board of directors of a patronage dividend. *Fruit Growers Supply Co.* v. *Commissioner,* 56 F. (2d) 90 (C. C. A. 9th); *Farmers Union Co-op. Co.* v. *Commissioner,* 90 F. (2d) 488; *Farmers Union State Exchange* v. *Commissioner,* 30 B. T. A. 1051. Cf. *Penn Mutual Co.* v. *Lederer,* 252 U. S. 523.

In the present case, the taxpayer argues that the declaration of patronage dividends by its board of directors was not a condition precedent to the members' right to the savings on the purchases made by them, on the theory that the taxpayers' articles of incorporation, its by-laws and the marketing agreement definitely created and fixed the liability of the taxpayer to its members, and that the present case comes within the Board's decisions in *Anamosa Farmers Creamery Co.* v. *Commissioner,* 13 B. T. A. 907, and *Farmers Union Co-operative Association* v. *Commissioner,* 13 B. T. A. 969.

A similar contention was made below, and the Board correctly reached the conclusion that neither the articles of incorporation, the by-laws nor the marketing agreement created any fixed liability, but that some definite act of appropriation was essential. The articles of incorporation provide (R. 42–43) that "the Board of Directors may declare other dividends or distribute earnings to the stockholding patrons of the cor-

poration'' whenever all cumulative dividends on preferred stock for all previous years shall have become payable, and the accrued dividends for the current year shall have been declared, and the corporation shall have paid such cumulative dividends for previous years and such accrued dividends for the current year, or shall have set aside from its surplus or net profits a sum sufficient for payment thereof. The articles of incorporation further provide (R. 43) that the net income of the corporation shall be distributed to the stockholding patrons, ''except such amounts as by law are required to be set aside for reserve funds, or *which may be set aside as reserve funds, by the Board of Directors* or by vote of stockholders''. (Italics supplied.) This exception is repeated in the by-laws of the company in Section 11 of Article VIII (R. 47), in Section 1 of Article IX, and in Section 1 of Article X (R. 48). The exception is also contained in the membership agreement. (R. 52.) It is perfectly clear, we submit, from the wording of the several instruments, that no patronage dividend was to be credited or paid to the members of the taxpayer until there had been a declaration of dividend by the board of directors, and that the board of directors, before declaring any dividend, was to make provision for any necessary reserve fund. This construction of these instruments is supported by the testimony of the general manager of the taxpayer, and by the chairman of the board of directors of the taxpayer. The general manager testified (R. 72) that no money was actually paid to members other than pursuant to resolution of the board of directors, and the chairman of the board of directors testified (R. 77) that no mem-

ber received any payment representing savings without a prior resolution adopted by the board of directors, and that when such resolution was adopted, the amounts were paid through the resolution to the members, that the company always held back what was needed toward the capital, and that the releases to the members were simply the amounts which were not necessary in the operation of the taxpayer's business. The general manager testified (R. 72) that no resolutions were adopted by the board when entries were made in the reserve for working capital. This statement, in conjunction with the statement of the chairman of the board of directors that the sums released to the members were the amounts which were not necessary in the operation of taxpayer's business, amply warrant the conclusion of the Board (R. 28, 29) that in keeping with the provision in the articles of incorporation referred to above, the board of directors excluded a certain portion of the taxpayer's earnings and placed it in the account entitled "Reserve for Working Capital".

We respectfully submit that the Board's interpretation of the taxpayer's articles of incorporation, by-laws and membership agreement as requiring corporate action before patronage dividends accrue is a reasonable construction of those instruments, and that accordingly the present case may not be adequately distinguished from this Court's decision in *Fruit Growers Supply Co.* v. *Commissioner,* 56 F. (2d) 90.

The Board's decisions upon which the taxpayer relies are adequately distinguished by the Board in its opinion in the *Fruit Growers Supply Co.* case, 21 B. T. A. 315, 327.

CONCLUSION

The decision of the Board of Tax Appeals is correct and should be affirmed.

Respectfully submitted.

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MARCH, 1940.

APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 101. EXEMPTIONS FROM TAX ON CORPORATIONS.

The following organizations shall be exempt from taxation under this title—

* * * * *

(12) Farmers', fruit growers', or like associations organized and operated on a cooperative basis (a) for the purpose of marketing the products of members or other producers, and turning back to them the proceeds of sales, less the necessary marketing expenses, on the basis of either the quantity or the value of the products furnished by them, or (b) for the purpose of purchasing supplies and equipment for the use of members or other persons, and turning over such supplies and equipment to them at actual cost, plus necessary expenses. Exemption shall not be denied any such association because it has capital stock, if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 per centum per annum, whichever is greater, on the value of the consideration for which the stock was issued, and if substantially all such stock (other than nonvoting preferred stock, the owners of which are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends) is owned by producers who market their products or purchase their supplies and equipment through the association; nor shall exemption be denied any such association because there is accumulated and maintained by it a re-

serve required by State law or a reasonable reserve for any necessary purpose. Such an association may market the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members, and may purchase supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of the purchases made for persons who are neither members nor producers does not exceed 15 per centum of the value of all its purchases. Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under this paragraph;

* * * * *

(U. S. C., Title 26, Sec. 103.)

Treasury Regulations 86 (promulgated under the Revenue Act of 1934):

ART. 101 (12)–1. *Farmers' cooperative marketing and purchasing associations.*—(*a*) Cooperative associations engaged in the marketing of farm products for farmers, fruit growers, live stock growers, dairymen, etc., and turning back to the producers the proceeds of the sales of their products, less the necessary operating expenses, on the basis of the products furnished by them, are exempt from income tax and shall not be required to file returns. For instance, cooperative dairy companies which are engaged in collecting milk and disposing of it or the products thereof and distributing the proceeds, less necessary operating expenses, among the producers upon the basis of the quantity of milk or of butter fat in the milk furnished by such producers, are exempt from the tax. If the proceeds of the business are distributed in any other way than on such a proportionate basis, the association does not meet the requirements of the Act and is not exempt. In other words, nonmember

patrons must be treated the same as members in so far as the distribution of patronage dividends is concerned, that is, if products are marketed for nonmember producers, the proceeds of the sale, less necessary operating expenses, must be returned to the patrons from the sale of whose goods such proceeds result, whether or not such patrons are members of the association. In order to show its cooperative nature and to establish compliance with the requirement of the Act that the proceeds of sales, less necessary expenses, be turned back to all producers on the basis of the products furnished by them, it is necessary for such an association to keep permanent records of the business done both with members and nonmembers. The statute does not require, however, that the association keep ledger accounts with each producer selling through the association. Any permanent records which show that the association was operating during the taxable year on a cooperative basis in the distribution of patronage dividends to all producers will suffice. While, under the Act patronage dividends must be paid to all producers on the same basis, this requirement is complied with if an association, instead of paying patronage dividends to nonmember producers in cash, keeps permanent records from which the proportionate shares of the patronage dividends due to nonmember producers can be determined, and such shares are made applicable toward the purchase price of a share of stock or of a membership in the association.

An association which has capital stock will not for such reason be denied exemption, (1) if the dividend rate of such stock is fixed at not to exceed the legal rate of interest in the State of incorporation or 8 percent per annum, whichever is greater, on the value of the consideration for which the stock was issued, and (2) if substantially all of such stock (with the exception noted below) is owned by producers who market their

products or purchase their supplies and equipment through the association. Any ownership of stock by others than such actual producers must be satisfactorily explained in the association's application for exemption. The association will be required to show that the ownership of its capital stock has been restricted as far as possible to such actual producers. If by statutory requirement all officers of an association must be shareholders, the ownership of a share of stock by a nonproducer to qualify him as an officer will not destroy the association's exemption. Likewise, if a shareholder for any reason ceases to be a producer and the association is unable, because of a constitutional restriction or prohibition or other reason beyond the control of the association, to purchase or retire the stock of such nonproducer, the fact that under such circumstances a small amount of the outstanding capital stock is owned by shareholders who are no longer producers will not destroy the exemption. The restriction placed on the ownership of capital stock of an exempt cooperative association shall not apply to nonvoting preferred stock, provided the owners of such stock are not entitled or permitted to participate, directly or indirectly, in the profits of the association, upon dissolution or otherwise, beyond the fixed dividends. The accumulation and maintenance of a reserve required by State statute, or the accumulation and maintenance of a reasonable reserve or surplus for any necessary purpose, such as to provide for the erection of buildings and facilities required in business or for the purchase and installment of machinery and equipment or to retire indebtedness incurred for such purposes, will not destroy the exemption. An association will not be denied exemption because it markets the products of nonmembers, provided the value of the products marketed for nonmembers does not exceed the value of the products marketed for members. Anyone who shares in the profits of a farmers'

cooperative marketing association, and is entitled to participate in the management of the association, must be regarded as a member of such association within the meaning of section 101 (12).

(*b*) Cooperative associations engaged in the purchasing of supplies and equipment for farmers, fruit growers, live-stock growers, dairymen, etc., and turning over such supplies and equipment to them at actual cost, plus the necessary operating expenses, are exempt. The term "supplies and equipment" as used in section 101 (12) includes groceries and all other goods and merchandise used by farmers in the operation and maintenance of a farm or farmer's household. The provisions of paragraph (*a*) relating to a reserve or surplus and to capital stock shall apply to associations coming under this paragraph. An association which purchases supplies and equipment for nonmembers will not for such reason be denied exemption, provided the value of the purchases for nonmembers does not exceed the value of the supplies and equipment purchased for members, and provided the value of the purchases made for nonmembers who are not producers does not exceed 15 percent of the value of all its purchases.

In order to be exempt under either (*a*) or (*b*) an association must establish that it has no net income for its own account other than that reflected in a reserve or surplus authorized in paragraph (*a*). An association engaged both in marketing farm products and in purchasing supplies and equipment is exempt if as to each of its functions it meets the requirements of the Act. Business done for the United States or any of its agencies shall be disregarded in determining the right to exemption under section 101 (12) and this article. An association to be entitled to exemption must not only be organized but actually operated in the manner and for the purposes specified in section 101 (12).

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